2002-SBE-002

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of	)	
	)	No. 61548
Save Mart Supermarkets & Subsidiary	)	
	)	

Representing the Parties:

For Appellant:	Jeffrey M. Vesely, Esq. Michael D. Herbert
For Respondent:	Geoffrey S. Way, Tax Counsel
Counsel for Board of Equalization:	Reed Schreiter, Tax Counsel

OPINION ON PETITION FOR REHEARING

Upon consideration of the petition for rehearing filed September 12, 2001, by respondent pursuant to section 19334[1] of the Revenue and Taxation Code, we deny respondent's petition because the arguments set forth in the petition do not constitute sufficient grounds to grant a rehearing as detailed in the *Appeal of Wilson Development, Inc.,* decided October 5, 1994, and California Code of Regulations, title 18 (Regulation), section 5082.1. Specifically, we find no error of law, lack of evidence, or irregularities in the proceedings with respect to our decision rendered August 14, 2001. In its petition, respondent requests publication of our opinion due to the potential impact on a large number of taxpayers, as well as offering guidance to respondent. We provide the following discussion of the grounds for our August 14, 2001, decision issued in favor of appellant.

[1] Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the year in issue.

The appeal was made pursuant to section 19324, subdivision (a), from the action of respondent in denying appellant's claim for refund in the amount of $235,938[2] for the year ended March 31, 1996. The parties raised three issues on appeal: 1) Whether Regulation section 23649-3, as adopted by respondent, is invalid as inconsistent with section 23649; 2) whether appellant is a "qualified taxpayer," as defined in section 23649, subdivision (c)(1);[3] and 3) whether respondent's disallowance of the credit as claimed by appellant violates the Due Process and Equal Protection Clauses of the United States and California Constitutions.

Appellant operates supermarkets throughout California. Each Save Mart store includes a meat department and many stores contain a full-service bakery department. In 1997, appellant filed an amended 1996 corporate franchise tax return claiming the Manufacturers' Investment Credit (MIC) for equipment it placed into service in its meat and bakery departments between January 1, 1994, and March 31, 1996. Respondent denied appellant's claim for refund, determining appellant was not a qualified taxpayer pursuant to section 23649, subdivision (c)(1), and Regulation section 23649-3, because appellant engaged in retail trade activities, defined in Division G of the Standard Industrial Classifications (SIC) Manual, rather than manufacturing activities, defined in Division D of the SIC Manual.[4] Appellant protested respondent's determination, but respondent affirmed its determination in a Notice of Action. Appellant timely appealed. The parties argued the appeal before this Board on August 14, 2001, at which time we rendered our decision in favor of appellant.

The statutory framework for this case is relatively simple. Section 23649 provides for an income tax credit to qualified taxpayers who incur qualified costs in the purchase of qualified property to be used primarily in any stage of manufacturing in California. Section 23649, subdivision (c)(1), defines a qualified taxpayer as any taxpayer "engaged in those lines of business described in Codes 2011 to 3999, inclusive, of the Standard Industrial Classification (SIC) Manual published by the United States Office of Management and Budget, 1987 edition." Respondent, in regulations effective May 31, 1996, interpreted the language of section 23649, subdivision (c)(1), to incorporate the entire SIC Manual classification system into California law with respect to determining a qualified taxpayer. Respondent thus specifically incorporated into its regulations the SIC Manual provisions for assigning SIC codes.

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[2] In the briefs filed by both parties before and after the hearing, the parties agree the amount of the refund claim should be reduced by $55,667 to account for duplicate costs claimed by appellant. We thus adopt this stipulated amount herein.

[3] Section 17053.49 sets forth similar provisions in the Personal Income Tax law, including an identical definition of "qualified taxpayer." Our discussion thus also appears to apply to those provisions.

[4] Section 23649, subdivision (c)(1), identifies SIC Manual codes 2011 through 3999, inclusive. These code sections comprise Division D of the SIC Manual, which identifies manufacturing activities.

Appellant argues Regulation section 23649-3, incorporating the SIC Manual provisions, is invalid on its face. Appellant contends the regulation adds numerous requirements to the definition of a qualified taxpayer not set forth in the statutory definition, such as requiring a taxpayer to operate a certain type of establishment in certain physical locations. This, appellant asserts, makes the regulation inconsistent with the statute, and thus invalid on its face (Gov. Code, §§ 11349, subd. (d); 11349.1, subd. (a)(4)), as respondent does not have the authority to alter or enlarge the statute. (*Whitcomb Hotel, Inc. v. California Employment Com.* (1944) 24 Cal.2d 753, 757.) Appellant contends the legislature set forth a simple definition of qualified taxpayer in section 23649, which refers to, but does not incorporate, the SIC Manual provisions. By this reference to the SIC Manual, appellant contends the legislature intended that any taxpayer engaging in an activity described in Division D of the SIC Manual, such as producing various bakery goods, should be treated as a qualified taxpayer. Appellant argues a reference to the SIC Manual does not, however, require a taxpayer's line of business to meet the stringent SIC Manual classification requirements, which respondent has adopted in its regulations. Appellant asserts respondent's approach is much too restrictive, given the legislature's intent to create jobs and stimulate the economy by fostering manufacturing activities in California. Respondent's regulation, appellant asserts, focuses on rigid rules, rather than on creating manufacturing jobs.

Respondent recognizes a regulation must be consistent and not in conflict with the statute, and reasonably necessary to effectuate the purpose of the statute. (Gov. Code, § 11342.2.) Respondent, however, counters that the legislature clearly intended to incorporate the entire SIC Manual classification scheme into California law by the language used in section 23649. (*Lennane v. Franchise Tax Board* (1994) 9 Cal.4th 263, 268.) Respondent thus contends its regulation is consistent with the statute and does not enlarge the statute. Given this clear legislative intent, respondent contends appellant's line of business must be identified and classified as manufacturing according to the SIC Manual classification system, as adopted in the regulation. Respondent notes the SIC Manual classification system requires an establishment to be "primarily" engaged in specified activities. Appellant's supermarkets, respondent argues, engage primarily in retail trade, as described in SIC Manual, Division G, of which its bakery and meat departments are merely a part. Respondent also notes the SIC codes relating to processing meat appear to apply to appellant's suppliers of meat, rather than to appellant, and SIC code 2051, cited by appellant, states that "[e]stablishments producing bakery products primarily for direct sale on the premises to household consumers are classified in Retail Trade, Industry 5461." Respondent thus asserts appellant's activities are directed at selling products at retail, whether the products are meat, bakery goods, or other grocery items, rather than being directed at manufacturing products. Respondent, recognizing that the SIC Manual and its own regulations allow for distinct and separate business activities performed at a single physical location to be classified separately under the SIC Manual, further argues appellant's bakery and meat departments do not qualify under the SIC classification scheme (and thus its regulation) as separate establishments.

With respect to our review of the validity of the regulation, both parties cite our previous decision in the *Appeal of Standard Oil Company of California,* decided March 2, 1983, which states the applicable standard of review as whether the regulation is arbitrary and capricious or has a reasonable or rational basis. Respondent contends, however, the more recent California Supreme Court decision of *Yamaha Corp. of America v. State Board of Equalization* (1998) 19 Cal.4th 1, holds that the standard of review depends on whether the regulation is quasi-legislative or interpretive. Respondent concedes the regulation at issue is merely interpretative, and thus receives lesser judicial deference. Despite this lesser deference, respondent asserts the regulation is valid.

After a thorough review of the *Appeal of Standard Oil Company of California, supra (Standard Oil),* and *Yamaha Corp. of America v. State Board of Equalization* (1998) 19 Cal.4th 1 (*Yamaha*), we conclude that, although the standard of review discussed and applied in *Standard Oil* is not incorrect, it may be incomplete under the applicable precedent. The California Supreme Court in *Yamaha* offers a broader, as well as an updated, review of the various precedents determining the appropriate standard of review, which guides our review of Regulation section 23649-3. It is clear, and respondent agrees, that the regulation at issue herein is interpretative, rather than quasi-legislative. Our review of the regulation, therefore, is guided by two categories of factors: 1) Those factors indicating respondent holds a comparative interpretive advantage; and 2) those factors indicating respondent's interpretation is probably correct.[5] (*Yamaha Corp. of America v. State Board of Equalization, supra,* 19 Cal.4th at p. 12.)

After reviewing the language of section 23649, subdivision (c)(1), and the requirements set forth in Regulation section 23649-3 in light of the factors guiding our review as discussed in *Yamaha,* we cannot escape the conclusion that Regulation section 23649-3 alters and enlarges on the words of the statute, and is thus invalid.[6] (*Whitcomb Hotel, Inc. v. California Employment Com., supra,* 24 Cal.2d at p. 757; see Gov. Code, § 11342.2.) Although we understand respondent's interpretation of section 23649, subdivision (c)(1), and laud respondent's efforts to timely and thoughtfully set forth an appropriate regulation, we conclude Regulation section 23649-3, by incorporating the entire SIC Manual classification scheme, imposes requirements on taxpayers not contemplated by the statute. As a result, the regulation includes provisions not reasonably necessary to effectuate the purpose of the statute. (Gov. Code, § 11342.2.) In fact, given our opinion (apparently concurred in by both parties) that the

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[5] The factors found in the first category "assume the agency has expertise and technical knowledge, especially where the legal text to be interpreted is technical, obscure, complex, open-ended, or entwined with issues of fact, policy, and discretion." (*Yamaha Corp. of America v. State Board of Equalization, supra,* 19 Cal.4th 1, 12.) The factors found in the second category "include[] indications of careful consideration by senior agency officials . . . , evidence that the agency 'has consistently maintained the interpretation in question, especially if [it] is long-standing . . ., and indications that the agency's interpretation was contemporaneous with legislative enactment of the statute being interpreted." (*Id.*, at p. 13.) Further, "[I]f an agency has adopted an interpretive rule in accordance with Administrative Procedure Act provisions . . . that circumstance weighs in favor of judicial deference." (*Id.*)

[6] We observe that since our conclusion regarding the first issue is decisive in this matter, we do not examine the contentions of the parties, nor reach conclusions, with respect to the remaining issues.

MIC legislation should be interpreted liberally in favor of taxpayers in order to effectuate the purposes of the legislation, the regulation actually hinders such interpretation, and thus hinders the legislative purpose of encouraging manufacturing in the state.

As a basis for our conclusion, we rely on several considerations. First, as discussed above, we believe the MIC should be interpreted liberally in favor of taxpayers. This goal is not accomplished by the multitude of requirements for determining a qualified taxpayer set forth in the regulation which eliminate its applicability to large segments of manufacturing jobs. Second, respondent's regulatory scheme contributes unnecessary complexity to an already complex statute. Third, and most importantly, the language of section 23649, subdivision (c)(1), does not contemplate or require the incorporation of the entire SIC Manual classification scheme in order to define a qualified taxpayer. As pointed out by appellant, the legislature used the phrase "described in," rather than "as classified in," or "shall apply," or "shall be applicable." The legislature regularly utilizes these alternative phrases when it intends specific incorporation of relevant information into California law. Further, the statute does not contain the words "establishments" or "primarily," nor does it necessarily include these concepts.[7] The SIC Manual "describes" numerous manufacturing activities. However, it is the SIC Manual, in assigning a specific manufacturing code to an entity, not the statute, that sets forth the classification scheme now embodied in respondent's regulation. The classification scheme is not necessary to the determination of a qualified taxpayer for purposes of the MIC. For example, section 2051 of the SIC Manual classifies an entity as engaged in the manufacture of bread and other bakery products if it is an "[e]stablishment[] primarily engaged in manufacturing fresh or frozen bread and bread-type rolls and fresh cakes, pies, pastries and other similar 'perishable' bakery products." In light of the additional requirements for application of the MIC found in section 23649, subdivisions (b) and (d), however, such a restrictive definition of qualified taxpayer as results from the SIC Manual classification scheme is not necessary. This is not to say, of course, that any entity or person purchasing an oven and baking bread qualifies for the MIC. Respondent's regulation, however, requires too much.[8]

In light of our conclusion that Regulation section 23649-3 is invalid, we must consider whether appellant is a qualified taxpayer for purposes of section 23649,

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[7] Respondent claims appellant focuses on the statutory words "described in" to support its position. Respondent counters that the statutory phrase "engaged in those lines of business described in" indicates the legislative intent to incorporate the SIC Manual classification scheme, which includes the concepts of establishments as single economic units at a single physical location and establishments primarily engaged in activities qualifying as manufacturing under the SIC classification scheme. We disagree with respondent that the quoted phrase includes the concepts from the SIC Manual.

[8] Appellant also argues that it is treated differently than other grocery store operations because its manufacturing operations occur on the same premises as the retail sale of its products, whereas other grocery store operators manufacture bread and process meat at separate locations. To the extent the SIC Manual "describes" manufacturing operations in this manner, we believe it is inconsistent with the legislative intent of fostering manufacturing activities in California.

subdivision (c)(1). Thus, we must determine if appellant is "engaged in those lines of business described in Codes 2011 to 3999, inclusive," of the SIC Manual. This language does not require appellant to be "primarily" engaged in the business of baking or meat processing. Thus, the fact that appellant's operations entail other activities constituting more than 50 percent of its total operations is not fatal to its claim. Further, although appellant's retail grocery store operations are described in other portions of the SIC Manual seemingly to the exclusion of its manufacturing activities, appellant does engage in activities described in Division D of the SIC Manual, such as meat processing and baking, as required by the statute. We also note that appellant's manufacturing activities constitute more than a trifling or irrelevant segment of its overall operations.[9] We, therefore, conclude appellant is a qualified taxpayer for purposes of section 23649, subdivision (c)(1).

In its initial briefing, appellant stated respondent conceded that appellant met the remaining two elements of the MIC, namely, purchasing qualified property and incurring qualified costs. Respondent countered in its opening brief that, to the contrary, respondent denied the MIC based solely on the fact that appellant did not meet the requirements for a qualified taxpayer, and thus no further analysis was required by respondent's auditor (i.e., no determination was made on whether the amounts expended on the property constituted "qualified costs" or "qualified property" for purposes of the MIC statute). Respondent further asserted its auditor did verify appellant paid sales tax on the property claimed, and that the property was capitalized. (Resp. Br., p. 2, fn. 2.) Respondent then stated "If this Board reverses respondent's determination, the MIC credit will be allowed without further verification of the specific items of property." (*Ibid.*) In its petition for rehearing, however, respondent now asserts appellant claims the MIC for numerous items of property not associated with manufacturing, but instead with its retail grocery operations. Unfortunately, this information does not appear to be information unavailable before the original hearing, and thus we will not consider it now on rehearing, particularly in light of respondent's previous statements that the MIC would be allowed to appellant without further verification. (See *Appeal of Alcon Realty Corporation N.V., et al.,* 96-SBE-016, Oct. 10, 1996; *Appeal of Wilson Development, Inc.,* 94-SBE-007, Oct. 5, 1994; Cal. Code Regs., tit. 18, § 5082.1.)

The petition for rehearing is denied.

[9] Appellant claims 1,004 employees (501 in its bakery departments and 503 in its meat departments) of its total 5,579 supermarket employees were employed in the bakery and meat departments during the period at issue. Further, appellant claims its bakery and meat department payrolls accounted for approximately $24 million of the total supermarket payroll of $120 million, and gross receipts from the two departments totaled approximately $196.5 million of appellant's total supermarket gross receipts of $1.13 billion. We do not find these to be insignificant amounts in the context of the MIC.

O R D E R

Pursuant to the views expressed in the opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED, AND DECREED, pursuant to section 19333 of the Revenue and Taxation Code, that the petition for rehearing filed by respondent is denied and that our original opinion reversing the Franchise Tax Board's denial of the claim for refund is sustained and modified as reflected in the attached written opinion.[10]

Done at Sacramento, California, this 6th day of February, 2002, by the State Board of Equalization, with Board Members Mr. Chiang, Mr. Klehs, Mr. Andal, Mr. Parrish, and * Ms. Marcy Jo Mandel present.

_____, Chairman

_____, Member

Dean Andal, Member

Claude Parrish, Member

*Marcy Jo Mandel, Member

*For Kathleen Connell per Government Code section 7.9.

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[10] As previously stated, the parties agree the amount of the refund claim should be reduced by $55,667 to account for duplicate costs claimed by appellant. Our order hereby reflects this reduced amount.